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SIPDIS

DEPT FOR EB/ESC; EUR/SNEC (MANN); EUR/CACEN (MUDGE)

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TAGS: ENRG EPET KZ

SUBJECT: KAZAKHSTAN: KMG LOOKING TO BUY INTO KARACHAGANAK

Classified By: POEC CHIEF DEBORAH MENNUTI, REASONS 1.4(B) and (D)

¶1. (C) Summary. Two expatriate oil executives told Econoff (in confidence) on November 14 that state-owned oil and gas company KMG has opened discussions with KPO (Karachaganak Petroleum Operating Company) members about buying a share of the consortium. British Gas (BG) Business Planning Manager Robert Flippin told Econoff that BG, unhappy with its joint-operatorship (with Italy's Eni) of the field, was considering selling part of its stake in return for KMG's support for its bid to become KPO's sole operator. On November 11, Gazprom's CEO Alexei Miller and President Nazarbayev reportedly discussed plans to renovate the Orenburg gas processing plant in order to receive increased volumes of Karachaganak associated gas -- a proposal which, if given on terms economical to KPO, would pave the way for expanded Karachaganak oil production. End Summary.

KMG TO BUY INTO KARACHAGANAK?

¶2. (C) Both Flippin and Karachaganak Representative Office Manager (and Eni secondee) Claudio Cogliati told Econoff that KMG had recently opened discussions with consortium members aimed at buying into KPO. Both men explained KMG's motives in fiscal terms. Karachaganak's 1997 Production Sharing Agreement (PSA), Flippin explained, limited the GOK's "take" to 8% during the field's "cost-recovery" phase. (Flippin added that these terms were among the most favorable to investors in all of Kazakhstan, likely equaled or exceeded only at Tengiz.) The GOK's share of revenues would improve dramatically after cost-recovery had been achieved. While the high price of oil had advanced that projected date to 2008-2010, Flippin said, KMG was still impatient to secure higher revenues, and saw buying into the consortium as the way to do so.

¶3. (C) Flippin told Econoff that BG would consider selling a minority KPO share to KMG in return for securing the GOK's support in its bid to become sole KPO operator. The current arrangement -- in which BG and Eni are "joint operators" and split project staffing, with each office rotating every two years -- was, in Flippin's view, "unwieldy," and, in Cogliati's, "inefficient." Flippin speculated that Eni would ultimately have to go along with a KMG decision to strip it of Karachaganak operatorship because Eni needed KMG support to maintain its increasingly-unpopular operatorship of the Kashagan field. (Note: Conoco-Phillips' Hakim Janah recently made a similar point, telling Econoff that while Eni's management of Kashagan was "terrible," Kashagan consortium members were powerless to vote Eni out as long as the Italian company had KMG's support. End Note.)

SEEKING A GAS DEAL...AS A WAY TO PRODUCE MORE OIL

¶4. (C) Following a November 11 meeting with President Nazarbayev, Gazprom CEO Alexei Miller told the press that a long-term agreement on gas deliveries from Karachaganak to the Orenburg gas processing plant "was in the works." Cogliati told Econoff that successful completion of the project depended on three things: the estimated \$300 million upgrade of the Orenburg facility, an expansion of the gas pipeline to meet the projected 15 billion cubic meters (bcm) per year delivery (up from the current 7 bcm), and "an acceptable price" for the Karachaganak gas. Flippin explained that Orenburg, as Karachaganak's monopsonistic buyer, currently paid only 30 cents per thousand cubic feet for KPO's gas, a price Gazprom had shrewdly calculated as being just above Karachaganak's break-even point. While KPO would be seeking a better price before agreeing to expand gas sales to Orenburg, Flippin noted, KPO's real objective was to increase production of oil. In that context, any cost-effective means of getting rid of Karachaganak's associated gas would be considered.

¶5. (C) Comment: Neither Flippin nor Cogliati identified any particular reason to reject KMG's advance, giving the impression that the keys to the deal will be price and the size of KMG's share. Presumably, given the GOK's December 2004 "preemption" legislation, either BG or Eni (or both) could sell part of their 32.5% KPO shares without the approval of consortium members Chevron (20%) or Lukoil (15%).

End Comment.

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